

# Accounting and Reporting Practice of Micro and Small Enterprises in West Oromia Region, Ethiopia

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## Abstract

Ethiopian MSEs are at early stage of development and face various constraints. One of the most crucial problems is related to proper record keeping and reporting. In order to promote MSEs as engines of growth, it is essential to understand the bottlenecks surrounding MSEs' accounting practice. The main objective of this study is therefore to examine the financial record keeping and reporting practices of MSEs in west Oromia sub-region. 200 sample MSEs selected from three towns in west Oromia region are used for this study. The finding indicated that the majority of MSEs did not keep regular accounting record and prepare periodic financial report. The main reasons mentioned by the respondents includes: smallness of the business, expensiveness of qualified accountants and lack of awareness about the benefits of accounting. The researchers recommend that concerned institutions such as MSEs agency and TVET colleges should arrange training for MSEs Operators.

**Keywords:** Record keeping, Micro and Small Enterprises, Financial reporting.

## I. INTRODUCTION

Accounting is said to be the language of business as it communicates the result of business operation to various parties who have an interest in the organization. Accounting can be used both by business and non business entities. Accounting information system is a collection of resources such as people and equipments designed to transform financial data into information useful for decision making. Accounting Information system is a set of interrelated subsystems which collect, record, and process data to information which is used to make quality decision. The information is communicated to a wide variety of users. The four most important financial reports prepared by business organizations are Income statement, statement of owners' equity, balance sheet and statement of cash flow. These reports are usually communicated to external users and top management as one of their base in making business decisions (Hall, 2008 & Mosich, 1989).

The practice of formal accounting in Ethiopia dates back to 1905, when the first bank of Abyssinia was opened in collaboration with Egypt. However, the 1960 commercial code of the Imperial government lied down a legal ground for the current accounting practice in the country. The 1960 commercial code of Ethiopia (Art 63-73) states that any person or business organization carrying on trade shall keep books and accounts as are required in accordance with the business practices and regulations, having regard to the nature and importance of the trade carried on. Further, the Ethiopian Income tax proclamation No.979/2008 specifies that business organizations that earn annual turnover of more than Br. 500,000(approximately \$20,000) are required to keep books of accounts.

MSEs have been recognized as being great contributors to the Ethiopian economy offering both employment and platform for innovative ideas. They form a larger percentage of the businesses that operate in the country as compared to their medium and large counterparts. They are however challenged by many constraints that hinder their performance and consequently their growth. One of the main constraints that have been highlighted over the years is lack of knowledge and skills in financial management. Keeping proper book of accounts is part of financial management which have paramount importance for the success of any firm, be it big or small. The purpose of this study is therefore to assess the current accounting and reporting practice of MSEs in west Oromia sub-region. To achieve this purpose, the remaining part of the paper is structured as follows. Section two presents the research problem including the objectives, section three reviews related literatures to the study. Section four presents the research design and methodology adopted in the study. Section five presents the result, analysis and discussion and finally section six concludes the paper.

## II. STATEMENT OF THE PROBLEM

Since the government of Ethiopia introduced MSE strategy and started rendering its support to MSEs, the private sector has rapidly grown in terms of number, capital and employees. The number of private businesses and limited companies had quickly risen and the majorities are MSEs. For instance, at the end of the first GTP, the government has planned to establish about three million MSEs in the country. Fortunately, the government has

surpassed this plan by creating above six million MSEs. The increase has partly resulted from the extensive growth of the number of graduates from universities, technical & vocational colleges.

Despite government's commitment to support MSEs and the achievements and contributions as mentioned above, researches in the field indicates that MSEs in Ethiopia are currently being faced with many serious difficulties such as shortage of capital for expanding and renovating equipment and technology, low productivity and competitiveness, lack of experience in terms of marketing, and financial management. Specifically, studies conducted in the capital city, Addis Ababa indicates that entrepreneurs who set up these enterprises lacked business management skills, capital, and as such, many of them faced a number of problems that include poor record keeping and financial management, which resulted in failure of most of such enterprises (Zeru, 2010; Mosisa, 2011).

Of these difficulties, lack of financial resource and lack experience of financial management are currently the most serious issues found in most research outputs (Ageba & Amha, 2006). Lack of source of finance and inefficient financial management may negatively affect MSEs' profitability and as a result, the difficulties of business enterprises will become greater. Conversely, efficient accounting and financial management will help MSEs to strengthen their profitability and, as a result, these difficulties can partly be overcome. MSEs that keep proper record of revenues and expenses know the profitability of their firm very easily. Further, keeping record of assets and liabilities will help to know the financial position of the enterprises at any time, helps to make strategic business decisions, secure credit from lending financial institution and pay reasonable amount of tax to the government (Mosisa, 2011).

MSEs in Ethiopia often face problems with regard to recording their daily transactions. This is due to the fact that most of the operators do not know how to make such records in a simple and easy manner. As a result, many operators find it very difficult to give information on their income and expenses and eventually do not know whether they have lost or profited from their business activities. The absence of recording will cause some problems in handling customer needs, particularly in maintenance services and also in cases of sales on credit services. The lack of recording also makes it very difficult for the tax offices to levy reasonable taxes that are commensurate with the business activities. As a result, business operators complain on the taxes that are levied on them on the basis of estimation which they say are too heavy to bear. The purpose of this study is to examine the accounting and reporting practice of MSEs in the west Oromia sub region.

West Oromiya sub-region occupies the western portion of Oromia regional state. It comprises Kelem Wellega, East Wellega, West Wellega, Horo Guduru, Jimma and Ilu Aba Bora zones (OFEDB, 2008). Specifically, the study depends on MSEs located in three towns in west Oromia sub-region which includes Jimma, Metu and Nekemte towns. West Oromia was selected for this study for several reasons. First, the seven zones in this region share common working culture and tradition. Second, while Jimma university is located in this sub-region, there are limited researches that identify problems of MSEs in this area and we, academic staffs, are responsible for identifying local problems & recommend solutions and finally, this part of the region accounts above 19 percent of the total population and 22.4 percent of the total area of the region, which is significant and needs great attention.

### III. LITERATURE REVIEW

Accounting is said to be the "language of business" because it deals with processing, interpreting and communicating information about a company's operations and finance to internal and external users. Accounting is extremely important to any organization whether it is small or big as financial information allows entrepreneurs to make informed business decisions. Economic events are measured and described by financial measures. We all work with and use accounting principles, whether we are managing a business, investing money, or just deciding how to spend our pay check.

Accounting information system is a collection of resources such as people and equipments designed to transform financial data into useful information. The information is communicated to a wide variety of decision makers. Accounting Information system is a set of interrelated subsystems which collect, record, and process data to information which is used to make quality decision. For accounting information system to be useful, the recording and reporting should be done in accordance with Generally Accepted Accounting Principles. Recording and organizing accounting information system will not meet its objectives unless reports from the systems are analyzed and used for making managerial decisions.

Specifically, keeping proper record and reporting the result plays a great role in MSEs. Keeping accurate books will help MSEs to Price their products accurately, know if they are making or losing money—in general and on specific jobs, know their cash flow – both in the short and long term, work with bankers and investors and Let the tax agencies know how they are doing. For all of these reasons, it is important for small businesses to use proper accounting practices. These practices involve properly recording all business receipts; making sure that only business expenses are included in the business's financial statements and on the tax return; and accounting properly for any debt incurred by the business and for any loans that the business makes to

related parties. Off course, most MSE operators do not need a complex accounting system but a rather simple introduction to a cash book and introduction to how to produce and keep records in the form of receipts, payments, costs, inventories.

Recently, with the company's development and growth, it is important for the managers of MSEs to understand and get involved in the accounting figures produced. Moreover, relevant accounting information could help users to make wise decisions. Accounting information is also viewed as relevant and very important to assist managers to reduce uncertainty in decision-making. This information can be obtained from proper financial statements which come from effective financial management. Damand (2003) argued that financial statements should be used to enable managers make decisions. Understanding financial statements that show the value of the investments in balance sheets and the income received shown in the income statements will help the managers to make simple decision. Well managed resources will make the investors or bankers to consider committing some funds to the same management. Thus, it is very important for the management to keep accounting record and prepare periodic financial statement.

In spite of the importance of accounting and reporting of financial information, it is unfortunate to find that these practices are often inadequate and lacking among MSEs. These rather limited usage of financial and management accounting concepts could be attributed to many factors. The first and the major reason is MSEs' inability to employ professionals in accounting and finance is due to their limited financial resources. In addition, lack of awareness of MSEs owners on the benefits of keeping accounting record and fear of high tax liability as a result of honestly keeping real record of financial transactions are reasons for lack of appropriate accounting record (Lakew & Kolech, 2013).

#### IV. RESEARCH DESIGN AND METHODOLOGY

Over the years, there have been many attempts at defining what constitutes MSE. However, there is no universally accepted definition for these kinds of business enterprises (Ayyagari et al., 2006). In fact it is not possible, because it depends not only on investment level and number of employee but also on technologies and technical complexities of production, degrees of skills demanded from workers and managers, end use of products, economic level of the country in which they operate, law of the land and so on, which varies from country to country. As a result, MSEs are often defined in many countries based on number of employees, total capital, total sales turnover, or total asset. Just like other developed and developing countries, MSEs in Ethiopia are defined on the bases of total capital and number of employees engaged. According to the 2011 revised MSE strategy, MSEs in Ethiopia are defined as shown in table 1 below.

**Table 1: Definition of Micro and Small Enterprises (MSEs)**

Type of Enterprise	Sector	No. Of Employee	Total Asset
Micro Enterprise	Industry	< 5	< Br.100,000 (\$6,000 or €4,500)
	Service	< 5	< Br. 50,000 (\$3,000 or €2,200)
Small Enterprise	Industry	6-30	< Br. 1.5 million (\$9,000 or €70,000)
	Service	6-30	< Br. 500,000(\$30,000 or € 23,000)

Source: FMSEDA (2011)

Research design is the science and art of planning for conducting studies so as to get the most valid findings (Kothari, 2004). Determining research design gives a detailed plan that is used to guide and focus on the research. This study is designed to describe the accounting and reporting practice of MSEs. Thus Descriptive research design is viewed as an appropriate research design for this study.

Generally, the first step in any sampling method is to identify the study population from where the samples would be drawn. Because of time and budget limitation, we decided to conduct the study in three major towns in west Oromia region including Jimma , Nekemte and Mettu towns. Therefore, the sample size for this study is determined to be 300 MSEs using a statistical model. Once the sample size is decided, stratified sampling technique was applied to take representative samples from each sector. The final sample MSEs were selected using stratified random sampling from each group. Sometimes when a given MSEs is not willing to participate in the interview or not found in their location, another one from the same vicinity was substituted.

To achieve the objective of the study, survey method was implemented to collect data using interview schedule. The questions are designed to get the opinion of respondents on issues related to accounting and reporting practices and related problems. After refining and translating the questionnaire, the data for the research were gathered through interview by trained enumerators. In this method, the enumerators go to the respondents premises and collect their opinion.

#### V. Result and Discussion

##### a. Characteristics Of MSEs Under Study

There are about 1,931 MSEs in the three towns till end of 2015 (Debelo et al., 2015 & Kebede et al.,2015).

These include; 888 in Jimma town, 420 in Metu town and 623 in Nekemte town. Out of these MSEs, the study has identified 300 MSEs using proportional stratified sampling techniques. Hence 300 copies of interview schedules are prepared and presented to respondents in the three towns. However, only 200 usable responses were obtained which is equivalent to 67 percent response rate. The result and analysis made afterwards are based on these 200 usable responses. The following table 2 presents the type of business, sectors in which the MSEs under study are engaged and legal ownership status of the MSEs under study.

**Table 2: Type of MSEs and Legal Form**

Type of Business		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Micro	143	71.5	77.3	77.3
	Small	42	21.0	22.7	100.0
	Total	185	92.5	100.0	
Missing	System	15	7.5		
Total		200	100.0		
Sector of the MSEs					
Valid	Manufacturing	77	38.5	41.6	41.6
	Construction	34	17.0	18.4	60.0
	Trading	30	15.0	16.2	76.2
	Service	31	15.5	16.8	93.0
	Urban Agriculture	13	6.5	7.0	100.0
	Total	185	92.5	100.0	
Missing	System	15	7.5		
Total		200	100.0		

As can be seen from table 2, the majorities of the firms are microenterprise which accounts for 77.3 percent and the remaining are small enterprises. With respect to sectoral classification, 41.6 percent are engaged in manufacturing business and 7.5 percent are engaged in urban agriculture. Low level of respondents engaged in urban agriculture means that there are very limited in number of this kind of MSEs in the three towns. The rest are almost equally divided among construction, trading and service sectors. In addition to type of the MSEs discussed above, the following table 2 summarizes the age of MSEs, Number of employee and Initial & current capital of the MSEs under study.

**Table 3 : Age, Number of Employee and Capital**

Interval	Age of MSEs (%)	No of Employee (%)
0 – 5	58.50	77.50
6 – 10	23.50	7.50
11 – 15	4.00	3.00
16 – 20	3.00	2.00
21 – 30	3.50	2.50
Missing	7.50	7.50
Total	100%	100%
Interval	Initial Capital (%)	Current Capital (%)
0 - 50,000	86.50	71.00
50,001 -100,000	2.50	6.50
100,001 - 500,000	0.50	8.00
500,001 - 1,500,000	2.00	6.00
Missing	8.50	8.50
Total	100%	100%

The minimum and maximum ages of MSE under study are one year and 40 years respectively with a mean of 6.3 years. From the above table 3, one can also see that about 82 percent of MSEs under study have an age of less than ten years. Number of employees in the MSEs ranges from a minimum of one employee to a maximum of 30 employees with an average number of 4.7 employees. About 77.5 percent of the MSEs under study have less than five employees which indicate that the majorities of the MSEs are microenterprises. About 86.5 percent of the MSEs started their operation with a total capital of less than 50,000 Birr, while 13.5 percent started their business with a capital ranging from 50,001 to 1.5 million Birr. In addition, above 71 percent of the MSEs still have capital balance less than Birr 50,000 at the moment which implies the majority of the MSEs under study are Micro enterprises by Ethiopian standard.

Most MSEs are owner-operated and understanding their profile in terms of human capital is important

as MSEs' survival, growth and productivity is related with the competency of their managers. Table 4 below illustrates survey results of owners/ managers profile in terms of age, educational status, and experience in the selected MSEs.

**Table 4 : Education, Age and Experience of the Respondents**

Education		Age of owners/Managers		Experience	
Academic level	%	Age Interval	%	Year interval	%
BA & Above	6.5	<= 25	10.5	0 – 5	43.5
TVET or Preparatory	41.0	26 – 35	53.5	6 – 10	28.5
Grade 10 and less	44.5	36 – 45	21.5	11 – 15	12.0
Illiterate	0.0	>= 45	6.5	>15	8.0
Missing	8.0	Missing	8.0	Missing	8.0
Total	100%	Total	100%	Total	100%

From the above table 4, we can see that about 44.5 percent of the respondents have grade 10 and less educational levels and about 47.5 percent have educational level above grade ten including TVET, Preparatory or BA degree. This might be as a result of the bulk of TVET and university graduates engaged in MSEs sector. A relatively similar finding was obtained by MOUDC (2013) regarding the educational status measured in terms of specific years of schooling among the surveyed MSEs. With respect to age, the minimum and the maximum age of the respondents are 18 years and 82 years respectively with a mean of 33.2 years. The majorities of the respondents are in the age interval between 26 – 35 years. This age structure is consistent with the nature of the business under consideration, i.e. laboriousness and limited access to infrastructure and machineries, which may not always allow aged people to participate in such activities as freely as their younger counterparts. This also goes in line with the provisions indicated in the Ethiopian MSE strategy that the youth are the main targets of the MSE strategy. Business experience in small firms capacitates the owners to have contact for obtaining business opportunities, financial resources and alleviating management challenges. With respect to business experience in this study, table 4 above shows that about 72 percent have experience less than 10 years.

**b. Accounting and Reporting Practice of MSEs Under Study**

One of the determinants of success and profitability of MSEs is financial management. A regular and organized record keeping practice enables owners/ managers of MSE to calculate profitability by clearly determining sales and expenditures and help to mitigate faults associated to production, marketing, and purchasing decisions. A question was raised to see whether MSEs under study can keep some sort of accounting record and who is responsible for that. The result of the survey is presented in table 5 below.

**Table 5: Keeping Accounting Record**

Do you keep accounting record?	%	Who will keep the record?	%
Yes, I keep very well	30	Owner/ Manager	80.00
No, I do not keep at all	33	Internal Accountant	15.50
Yes, but only partially	37	External Accountant	3.50
		Accountants from MSE Agency	2.00
Total	100%	Total	100%

As can be observed from table five, only one-third of the respondents keep regular accounting record. About 70 percent of the respondents either do not totally keep accounting record or keep the record irregularly. For those that are keeping accounting record, owners or managers are responsible in the majority of the cases. The use of qualified internal or external accountant is very much limited. This implies that MSEs do not realize the inaccuracy of information based on their limited knowledge will affect the decision making process and will jeopardize their companies' performance. This indicates that the quality of accounting information produced is quite low because owner/managers may have insufficient accounting knowledge. As opposed to this finding, almost three-quarters of Austrian MSEs keep regular accounting record and outsource the preparation of their financial statements to outside experts ((Linder & Hoelzl, 2012).

Because of their size and limited capacity, MSEs in Ethiopian are unable to keep book of accounts and prepare financial report by their own. Accountants assigned from MSEs agency are supposed to provide accounting service to them. The reason is that these small firms do not have the capacity for sound financial management systems in place which will enable them to prepare financial reports. The end result is that it becomes very difficult for tax authorities to compute their taxable incomes. However, with respect to this survey, only two percent of the respondent confirmed that accountant from MSE agency are coming and keeping accounting record for their business.

When compared among three towns, those MSEs found in Mettu and Nekemte town are better in keeping accounting record as compared to those in Jimma town. There is also a significant association between size of MSE and keeping accounting records with  $\chi^2 = 3.987$  at 5% level of significance. That is, small

enterprises are better in keeping accounting record as compared to micro enterprises. This is because small enterprises are relatively capable of employing accountants or financially able to outsource the responsibility to external accountants.

From the above analysis one can see that the tendencies of recording their businesses operations on regular basis have been weak in MSEs. Regular, in this case, means a tendency at which MSEs record their business transactions, on a daily, once in two days, weekly, once in a fortnight or monthly. The frequency at which they record their business clearly indicates how much traditions of keeping financial records are entrenched in their operation. It is also clear that those businesses with a daily record keeping practice are obviously better than those keeping their records on a weekly or monthly basis. Respondents were also asked factors that hindered them not to keep proper accounting record. The following bar graph (figure 1) depicts the major reasons for not having proper record system.

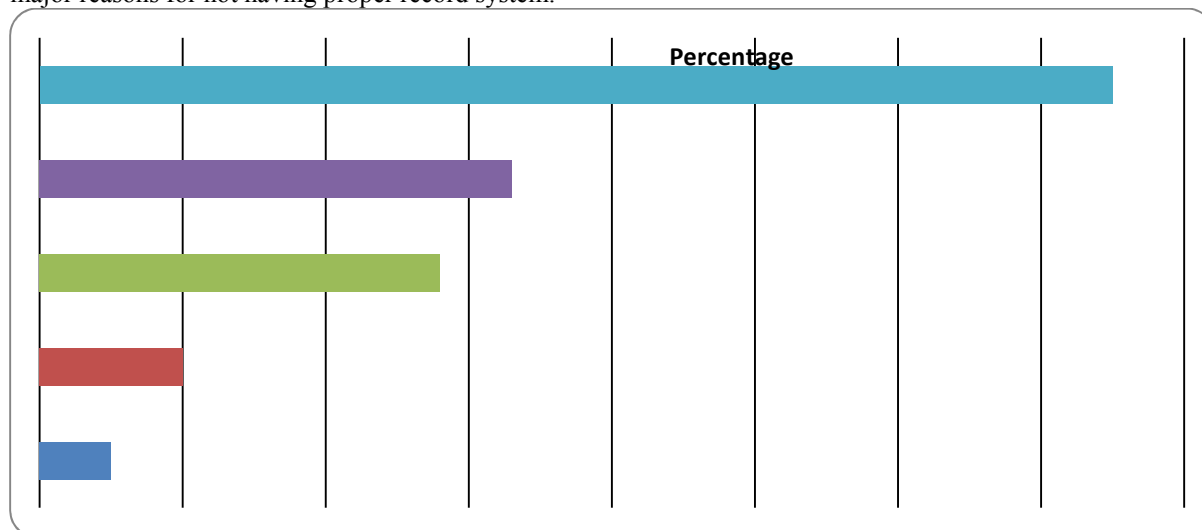


Figure 1: Reasons for not keeping accounting Records

As can be seen from the figure 1 above, perception that the business is too small to qualify for accounting record is the main reason for not keeping book of accounts. Even those that are keeping accounting record, owners or managers use instinctive method than the formal accounting procedures we are teaching at college or university. This is typical management behavior of even in larger enterprises conceivably due to inadequate awareness and skill of most of our business people. Other reasons for not keeping accounting record include lack of qualified accountants at appropriate pay rate and fear of high taxation as a result of honestly keeping accounting record. Another factor that discourage from keeping proper record may be; per income tax proclamation 286/2002, MSEs whose annual turnover is less than Birr 500,000 (\$20,000) are not legally required to keep book of accounts for tax purpose. Therefore, record keeping by MSEs is based on the willingness of the owners themselves.

Similar to Ethiopian, the culture of keeping accounting record among MSEs is minimal in Ghana. The three most important factors that prevent them from practicing sound accounting system were: (1) Qualified accountants too expensive to employ (93 percent); (2) Accounting records too difficult to understand (87 percent); (3) Lack of internal accounting staff (73 percent) (Kwame & Mensah,2010). However, as opposed to Ethiopia, in Austria, since record keeping for tax purpose is mandatory, the majority keep regular book of accounts. Off course most MSEs outsource the preparation of financial statements to specialist service providers. Almost three-quarters of all Austrian MSEs outsource the preparation of their financial statements to specialist service providers. But MSEs in Australia also face some challenges in relation to their accounting obligations. More than half of Austrian MSEs consider the complexity of accounting requirements and the time required for preparing accounting and financial reports as very or rather high (Linder & Hoelzl, 2012). The respondents were also asked to identify the kinds of accounting record they keep. The following figure 2 presents the result of the survey.

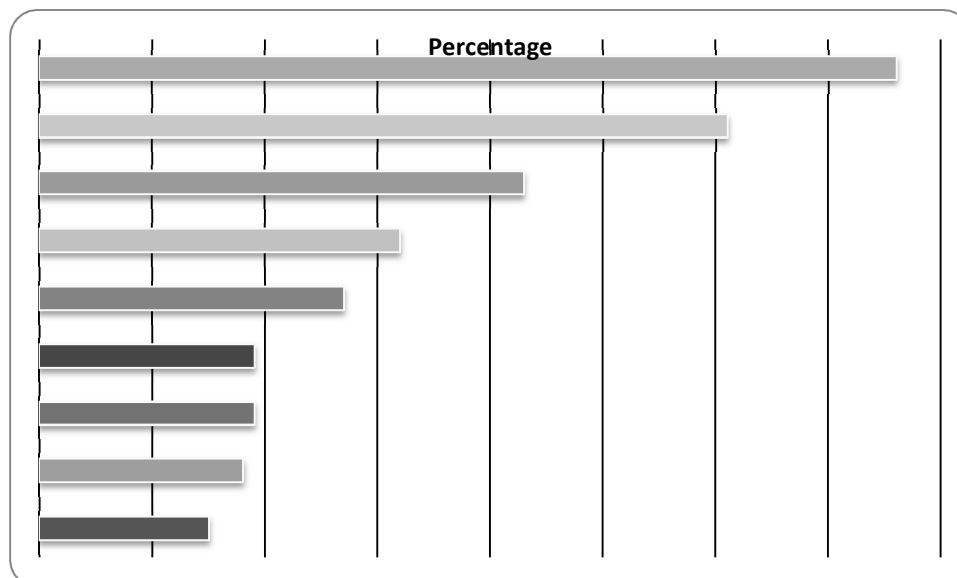


Figure 2: Major type of reports

As can be seen from the figure 2, the most common types of accounting record kept by the respondents include: sales records, purchase and payroll records. Records for assets and liability have got minimum attention among MSEs under study. Respondents were also asked the type and frequency of report they prepare and the result is summarized in the table 6 below.

**Table 5: Reporting Practices**

Types of Report	%	Frequency of preparing Report	%
Sales Report	45.52	Daily	17.91
Profit and loss Report	69.4	Monthly	55.22
Balance sheet Report	25.37	Quarterly	28.36
Purchase Report	30.6	Semi annually	15.67
Cash flow Report	32.84	Annually	23.13

As can be seen from table 6 above, the most common types of report prepared by MSEs include income statement and sales report. In addition, the majority of the respondents prepare the report on monthly or quarterly time interval.

## VI. Conclusion and Recommendation

This study found that the level of awareness on the importance of keeping book of accounts and financial management is still very low in MSEs under study. The majority of the MSEs under study do not keep regular financial records. The main reasons for not doing so include smallness of the MSE and expensiveness of qualified accountants. Most of the owners or managers are also not aware of the importance of keeping regular accounting records. For those that are keeping regular accounting record, the most commonly kept record includes sales, purchase & payroll record and the common types of report prepared from these records is the profit and loss statement. From this, it is obvious to see that accounting records should be in an orderly manner and complete with all the important data regarding their business transactions. Armed with complete accounting data, managers should produce a good quality and reliable financial report that will assist and equip them with accurate accounting information for decision making. Thus, this should consequently guide MSEs to make a quick and precise decision. But all these things are missing in the MSEs under study which implies that most of them are not using financial information obtained from formal accounting record in their day today business decision. The researchers recommend the concerned institutions such as MSEs agency, Universities and TVET colleges should arrange training for MSEs Operators.

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